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JOINT COMMITTEE ON FINANCE

MEMORANDUM

To: Members
Joint Committee on Finance

From: Senator Mark Miller
Representative Mark Pocan

Date: February 1, 2010

Re: SWIB Report on Improvements in the Investment of the Retirement
Trust Funds

Attached is a report on improvements in the investment of the retirement trust funds pursuant to section 9126(1h)(a) of the 2007 Wisconsin Act 20.

This report is being provided for your information only. No action by the Committee is required. Please feel free to contact us if you have any questions.

Attachments

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BY: St. Finance

January 28, 2010

Senator Mark Miller, Co-Chair
Joint Committee on Finance
Room 317 East
State Capitol

Representative Mark Pocan, Co-Chair
Joint Committee on Finance
Room 309 East
State Capitol

Senator Kathleen Vinehout, Co-Chair
Joint Legislative Committee on Audit
Room 104 South
State Capitol

Representative Peter Barca, Co-Chair
Joint Legislative Committee on Audit
Room 107 North
State Capitol

Dear Committee Co-Chairs:

Pursuant to section 9126(1h)(a) of 2007 Wisconsin Act 20 (the 2007-09 biennial budget), this report describes improvements SWIB is making in the investment of the retirement trust funds with the additional authority provided in Act 20. Most of the potential investment initiatives discussed during the budget deliberations have been implemented and the initial results are encouraging.

Since December 31, 2007, the share of retirement fund assets managed internally has risen from 21% to 41% due to greater budget and position authority. SWIB has achieved approximately \$6.4 million in net annual cost savings as a result and has improved investment returns in a number of areas.

Additional budget authority resources and the modernization of SWIB's investment authority in 2007 Wisconsin Act 212 played a significant role in achieving exceptional investment performance in 2009. For example,

- The Core Fund's one-year return of 22.2% exceeded its benchmark by 2.3%, and the Variable Fund's one-year return of 33.7% exceeded its benchmark by 1.7%;
- By outperforming benchmarks, SWIB generated over \$1.2 billion in added gains for the retirement trust funds in 2009, with approximately \$464 million coming from internally managed public market strategies;
- The Core Fund's asset management is considered low cost by CEM Benchmarking, Inc. when compared to peer funds of a similar size and asset mix.

Background

The primary mission of the State of Wisconsin Investment Board (SWIB) is to invest the assets of the Wisconsin Retirement System (WRS). SWIB relies on its professional staff and outside firms to manage investments in public and private markets around the globe.

SWIB receives no general purpose revenue. All internal and external costs are paid by the trust funds under management. Fees paid to money management firms are charged directly to the trust funds and are not part of SWIB's internal operating budget.

The statutes establish SWIB's budget authority for internal operating costs as a percentage of the market value of assets under management. Act 20 raised this percentage from 0.0275% (2.75 basis points) to 0.0325% (3.25 basis points) over a two-year period. The purpose of the law change was to increase SWIB's capacity to manage assets internally and to reduce dependence on more expensive outside money management firms.

Act 20 also established a new method for determining the "budget floor" that protects SWIB's ability to continue essential operations if a severe downturn causes the market value of assets to decline. The statutes now adjust the budget floor to the level of SWIB's budget authority in the second year of the previous biennium (currently \$30.0 million). This change recognized that as SWIB expands its internal investment operations the budget floor also needs to increase.

In 2008 and early 2009, investors experienced the most difficult market conditions since the 1930s. The market value of assets under SWIB's management fell from \$93.7 billion as of December 31, 2007, to a month-end low of \$61.9 billion as of February 28, 2009. As a result, SWIB's budget authority for FY 2009 and FY 2010 was at the budget floor of \$30.0 million and will remain at that amount until assets grow to \$92.4 billion.

During the 2007-09 budget deliberations, it was understood that increased budget authority would be used to fund additional staff authorized in subsequent s. 16.505 requests. These requests were approved in December 2007 (9.0 positions) and September 2008 (10.75 positions).

The actual amount billed to the trust funds for internal operating expenses in fiscal years 2008 through 2010 was \$6.4 million less than authorized by Act 20, and the amount billed in fiscal year 2010 is less than the amount billed for fiscal year 2009 by \$0.9 million. Delays in receiving authorization to fill positions contributed to these reduced expenditures. As remaining positions are filled, we anticipate that the operating budget may rise in FY 2011 but remain within SWIB's current budget authority.

Operating Budget and Positions			
Fiscal Year	Budget (in millions)		Authorized Positions
	Authorized	Billed	
2007	\$22.5	\$22.5	104.50
2008	\$25.7	\$24.8	113.50 (as of 12/2007)
2009	\$30.0	\$27.7	124.25 (as of 9/2008)
2010	\$30.0	\$26.8	124.25

The 9.0 additional positions authorized in December 2007 were all filled. To date, SWIB has filled 7.25 of the 10.75 positions authorized in September 2008. As SWIB is prepared to fill positions, it has successfully sought and obtained exemptions from the state imposed hiring freeze by the Department of Administration (DOA). To date we

have received approval to fill two of the remaining 3.5 positions so the investment initiatives can be fully supported.

Investment Initiatives

Under exceptionally challenging market conditions, SWIB began a number of major initiatives in 2008 and 2009 that are described in Attachment 1. As market conditions have changed, these initiatives have evolved somewhat from those proposed in the 2007-2009 Biennial Budget Request Supplement dated December 14, 2006. To date, the initiatives we have implemented have resulted in:

- The transfer of nearly \$13.3 billion (including market gains) from external management to internal management at an annualized net savings of nearly \$6.4 million in 2009 (see Attachment 3);
- Over \$464 million in gains from internally managed public market investment strategies over the retirement funds' investment benchmarks in 2009; and
- New multi-asset strategies to take advantage of current market opportunities and dampen the risk of volatile equities markets.

I would be happy to address any questions you may have now or in our March 31 annual report that will provide a broader discussion of markets and SWIB's strategies and performance.

Sincerely,



Keith Bozarth
Executive Director

Cc: Members, Joint Committee on Finance
Members, Joint Legislative Committee on Audit
Robert Lang, Legislative Fiscal Bureau
Janice Mueller, Legislative Audit Bureau
Joe Malkasian, Clerk for Joint Committee on Finance

Attachment 1

Use of Additional Budget Authority and Positions

A. Global Sector Equities Portfolios

Until 2007, SWIB internally managed large company domestic equities in three dedicated portfolios and a healthcare sector portfolio. At the end of 2007, SWIB began to realign these holdings into one large company stock portfolio and ten industry sector portfolios to provide more efficient market coverage. Additional budget authority enabled SWIB to add five analysts to improve depth of coverage and to actively manage seven of the ten sector portfolios by the end of 2009. The other three sector portfolios are being passively managed internally.

As shown in Attachment 3, funds moved from external management to the sector portfolios resulted in a net annualized cost reduction of nearly \$1 million. Six of the ten sector portfolios met or exceeded their benchmarks in 2009, and over \$32 million in value has been added since the inception of the sector strategy in 2008.

B. International Equities Portfolio

Effective January 1, 2010, SWIB combined its internally managed international equity portfolio with the internally managed domestic sector portfolios to create global sector portfolios – as outlined in SWIB's 2007-09 biennial budget plan. This transition was made possible in part by enhancements in the trading room, operations and technology staffed by additional positions approved in 2007 and 2008.

Leading up to the implementation of the global sector equities strategy, SWIB moved over \$2.3 billion (reflecting 2009 market value increases) from external management to the internal international portfolio, resulting in a net annualized cost reduction of nearly \$3.3 million. An additional research analyst from the new budget and position authority was added to support the international portfolio during 2009.

Prior to the international portfolio assets being transitioned to the sector strategy in December 2009, investment performance exceeded the benchmark for the one- and three-year periods. The one-year value added over the benchmark was \$121.1 million through November 30, 2009, the last reporting period prior to the transition of assets to the sector strategy.

C. Equities Index Portfolio

One of the additional authorized positions enabled SWIB to move its investment in the Russell 1000 Index of large company domestic stocks from external to internal management. This portfolio continues to meet its objective to match the index return. As of December 31, 2009, the portfolio is valued at more than \$9.2 billion. An additional \$1.47 billion was transitioned to the portfolio in 2009 from external management. The annual net cost savings from managing \$9.2 billion internally is estimated to be approximately \$2.4 million. SWIB is also able to achieve more favorable securities lending arrangements by managing the assets internally, and the market research benefit from equity commissions is retained by SWIB.

D. Small Company Equities Portfolio

In 2008, SWIB conducted a review of its internally managed small company domestic equities portfolios, taking into consideration practices followed by "best in class" managers. This was similar to the review of SWIB's large company equity portfolios completed in 2007 that led to a number of improvements. The review of small company portfolios identified a number of enhancements in the allocation of funds among managers and investment process that SWIB began to implement in 2008.

In June 2009, SWIB hired a new small cap equity analyst to provide additional analytical and research support for the two internally managed small cap portfolios. Performance for the small cap portfolios improved in 2009 and \$120.3 million in value added was created for the trust funds.

E. Fixed Income and Currency Overlay

During 2009, as a result of asset class rebalancing, two offsetting fixed income asset transitions were completed resulting in a net of \$4.8 million in fixed income assets moving to external management. The net cost impact of the 2009 asset transitions was negligible. SWIB continued to realize 2009 net cost savings of nearly \$0.6 million from asset transitions to internal management completed in 2008 (see Attachment 3). SWIB's internally managed fixed income portfolios generated \$203.6 million in value over their benchmarks in 2009.

SWIB's investment staff has opportunistically used a currency overlay strategy to enhance the management of foreign currency exposure across all asset classes. An internal team led by global fixed income staff seeks to capture additional investment return from inefficiencies in the currency markets. In 2008, the strategy generated investment gains of \$44 million to take advantage of an overvalued Euro, and gains of \$3.8 million were realized in 2009 on a Dollar/Yen currency strategy. Improvements in fixed income strategies are supported by one of the additional positions SWIB received.

F. Analytics and Funds Management

Over the past two years, SWIB implemented several new investment strategies in the multi-asset class, which contains opportunistic and other investments that do not fit in traditional asset classes. The goal of the strategies is to increase Core Fund returns with minimal added risk. The Core Fund allocation target for the multi-asset portfolios is 4%. The investment strategies described below were made possible in part by the recent modernization of SWIB's statutes and additional budget and position authority. SWIB added one quantitative analyst in 2008 and is now recruiting for an additional analyst position to provide further support in this area.

Credit Beta Portfolio:

In the fourth quarter of 2008, SWIB implemented a strategy to take advantage of the abnormally wide spread in yields between non U.S. government debt and U.S. Treasuries that resulted from the severe liquidity crisis in the credit markets. The portfolio gained exposure to credit through investing in corporate bonds and mortgage obligations and hedging away exposure to interest rates. As a risk control measure, these investments were combined with an overlay that replicated the Core Trust Fund allocation through futures and physical securities. This strategy produced over \$205

million in added gains over the benchmark in 2009 as the credit markets returned to more normal yield spreads during the year.

Term Structure Portfolio:

SWIB implemented a strategy to attempt to take advantage of the unusually wide spread in yields between the 5-year U.S Treasury note and the 10-year U.S. Treasury note in July 2009. Although this strategy realized a loss of \$13.2 million in 2009, it is expected the strategy will ultimately realize gains in future months as the spread between the 5- and 10-year Treasury notes narrows to a more normal level.

Options Overlay:

A strategy of writing option contracts was implemented in July 2009 to realize additional gains from the regular rebalancing of asset classes to target asset allocations. This strategy has realized \$1.1 million in value added in the six months following its inception in 2009. Since this strategy has been initially successful, SWIB may expand the use of writing option contracts in conjunction with the rebalancing regimen to realize additional income.

Rebalancing with Futures Contracts:

SWIB routinely rebalanced public equities to its long-term asset allocation target as global stock markets fell in 2008 and early 2009. In addition to buying and selling physical securities, SWIB also used low cost futures contracts to rebalance asset classes. This saved approximately \$8 million in transaction costs in 2009 that would have been incurred by buying and selling the physical securities. Regular and disciplined rebalancing of the Core Fund asset classes during the volatile market swings contributed to the significant increase in returns in 2009 when equity markets eventually rebounded.

G. Private Equity and Real Estate

SWIB was authorized two additional positions in September 2008 to help provide analytical support for the growing amount of funds invested in real estate and private equity limited partnerships. In December 2008, SWIB increased the allocation to each of these investment types from five to six percent of Core Fund assets to enhance returns and manage risk. SWIB delayed requests to the Department of Administration to fill the two positions when the collapse of the credit markets created an upheaval in real estate and private equity markets.

In January 2010, SWIB requested and received approval from DOA to begin recruiting for the real estate position. The position will help strengthen relationships with fund managers and assist with the additional due diligence and monitoring as new opportunities arise.

H. Technical Support

As described in our 2007-09 budget request and subsequent s. 16.505 requests, the investment initiatives SWIB is undertaking require significant support from accounting, information technology, legal and other staff. Three of the support positions authorized in December 2007 and 3.25 of the positions authorized in September 2008 have been filled.

In 2008 and 2009, these staff: (a) provided the support necessary to launch and manage the ten new global equities sector portfolios; (b) executed at least 13 separate transitions of assets in 2008 and 17 in 2009 among internal and external managers; (c) supported new investment strategies including futures contracts, options and currency overlays; (d) helped the WRS achieve a record \$93 million in earnings from securities lending in 2008 and additional savings during 2009 in difficult market conditions; and (e) supported the needs of the staff added to increase internal asset management.

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Attachment 2

Management of Wisconsin Retirement System Trust Funds

	12/31/2007		12/31/2008		12/31/2009	
	Amount (in millions)	Percent	Amount (in millions)	Percent	Amount (in millions)	Percent
Internally Managed	\$18,192	20.7%	\$23,263	37.6%	\$30,017	41.2%
Externally Managed Dedicated Accounts	16,060	18.3%	11,742	19.0%	14,332	19.7%
Externally Managed Commingled Accounts	53,551	61.0%	26,798	43.4%	28,496	39.1%
1. Passive Index Funds	25,566	29.1%	10,008	16.2%	12,530	17.2%
2. Enhanced Index Commingled Funds	18,665	21.3%	7,886	12.8%	5,668	7.8%
3. Limited Partnerships	5,744	6.5%	6,419	10.4%	5,945	8.2%
4. Actively Managed Commingled Accounts	3,577	4.1%	2,486	4.0%	4,353	6.0%
TOTAL WRS Assets	\$87,803	100.0%	\$61,803	100.0%	\$72,845	100.0%

Net Cost Saving Summary of New Investment Initiatives*
Calendar Years 2008 & 2009

Attachment 3

Initiative	Assets Moved To Internal Management		Positions		Cost Impact				
	Market Value of Assets Moved in 2008	Market Value of Assets Moved in 2009	Total Authorized Positions 16,505	Positions Filled	2009 Increase in Internal Costs (Point Budget)	2009 Increase in Internal Costs (Direct Charge)	Total 2009 Increase in Internal Costs	2009 Reduction in External Management Fees	2009 Net Reduction in Costs
A Global Sector Equities Portfolio	\$ 1,265,000,000		5.0	5.0	\$ 900,400	\$ 350,000	\$ 1,250,400	\$ 2,212,000	\$ (961,600)
B International Equities Portfolio	\$ 2,035,000,000	\$ 270,000,000	1.0	1.0	\$ 121,400	\$ 70,000	\$ 191,400	\$ 3,482,200	\$ (3,290,800)
C Equities Index Portfolio	\$ 7,767,000,000	\$ 1,474,000,000	1.0	1.0	\$ 237,900	\$ 70,000	\$ 307,900	\$ 2,739,300	\$ (2,431,400)
D Small Company Equities Portfolio			1.0	1.0	\$ 121,400	\$ 70,000	\$ 191,400		\$ 191,400
E Fixed Income and Currency Overlay	\$ 448,000,000	\$ (4,800,000)	1.0	1.0	\$ 195,500	\$ 70,000	\$ 265,500	\$ 833,100	\$ (567,600)
F Analytics and Fund Management			2.0	1.0	\$ 163,700	\$ 70,000	\$ 233,700		\$ 233,700
G Private Equity and Real Estate			2.0	0.0	\$ -	\$ -	\$ -		
H Technical Support			6.75	6.25	\$ 471,800	\$ -	\$ 471,800		\$ 471,800
Total	\$ 11,515,000,000	\$ 1,739,200,000	19.75	16.25	\$ 2,212,100	\$ 700,000	\$ 2,912,100	\$ 9,266,600	\$ (6,354,500)

* All estimated cost amounts above are annualized

Summary:

- SWIB received authority for 19.75 additional positions in two separate requests to support increased internal asset management capabilities
- As of 12/31/09 16.25 of the newly authorized positions were filled
- Cost analysis shows the savings associated with a reduction in external management fees more than offsets the additional cost of internal management.

